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Kentucky Law Survey: Corporations

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Corporations

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In developing the present Survey article, an approach similar to that used in previous Surveys has been used.[1] Attention will be directed first to a group of cases affecting corporation law at the federal level. These federal developments will be discussed in the context of two recent decisions by the United States Supreme Court involving the scope and application of the federal securities laws. Also, two decisions by the Sixth Circuit Court of Appeals relating to the elements necessary to state a cause of action under the Securities and Exchange Commission (SEC) rule 10b-5 will be analyzed. This review will be followed by discussion of a series of cases dealing with corporate principles under state law.

Discussion of state law developments will begin by examining a decision from the United States Supreme Court relating to shareholder derivative suits. This commentary will be followed with a case from the Seventh Circuit Court of Appeals dealing with the subject of insider trading under state law. The Survey will conclude with discussion of a decision by the Supreme Court of North Carolina concerning shareholder agreements and with an examination of a decision by the Kentucky Court of Appeals relating to the maintenance of suits in the Kentucky courts by foreign corporations that have failed to qualify to do business in the state.

I. Federal Corporation Law

A. *Fraud Against Brokers*

During the period covered by the present Survey, the United States Supreme Court remained active in considering cases involving claimed violations of the federal securities laws. One

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[1] For previous corporation law surveys, *see* Ham, *Corporations*, 67 Ky. L.J. 457 (1978-79); Ham, *Corporations*, 66 Ky. L.J. 477 (1977-78); Ham, *Corporations*, 65 Ky. L.J. 255 (1976-77); Ham, *Corporations*, 64 Ky. L.J. 253 (1975-76); Ham, *Corporations*, 63 Ky. L.J. 739 (1974-75).

of these cases, *United States v. Naftalin*,[2] concerned a criminal prosecution brought under section 17(a) of the Securities Act of 1933,[3] dealing with fradulent conduct in the offer or sale of securities.

Naftalin, a professional investor, was charged with participating in a fradulent short-selling scheme.[4] He had placed sell orders with several brokers for stocks which he did not then own but which he thought had peaked in price.[5] His plan was to make offsetting purchases of these stocks through other brokers at lower prices when the market declined as a means of fulfilling his sales commitments with the first group of brokers.[6] His aim was to profit from the resultant difference in prices.[7] Since he realized that the first group of brokers would have refused to execute his sell orders or would have required margin deposits from him had they known he did not own the securities, he falsely represented to them that he owned the shares which were the subject of the sell orders.[8]

As it turned out, the market price of the securities which Naftalin ordered to be sold rose sharply instead of declining, and he was unable to make the necessary covering purchases which would have enabled him to deliver the securities to the first group of brokers for completion of his sales.[9] The brokers were forced to borrow securities to meet their delivery obligations and to purchase replacement shares on the open market at the higher prices to enable them to return the borrowed

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[2] 441 U.S. 768 (1979).

[3] 15 U.S.C. § 77q(a)(1) (1976).

[4] 441 U.S. at 770.

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] *Id.* SEC rule 10a-1(d), promulgated under § 10(a) of the Securities Exchange Act of 1934 provides:

> No broker or dealer shall mark any order to sell a security registered on, or admitted to unlisted trading privileges on, a national securities exchange "long" unless (1) the security to be delivered after sale is carried in the account for which the sale is to be affected, or (2) such broker or dealer is informed that the seller owns the security ordered to be sold and, as soon as is possible without undue inconvenience or expense, will deliver the security owned to the account for which the sale is to be effected.

17 C.F.R. § 240.10a-1(d) (1979).

[9] 441 U.S. at 770-71.

stock.[10]

Naftalin was charged in a criminal indictment with fraudulent conduct in violation of paragraph (1) of section 17(a) of the Securities Act, which condemns the employment of "any device, scheme, or artifice to defraud" in the offer or sale of securities.[11] The United States District Court for the District of Minnesota found Naftalin guilty of the violations charged and sentenced him to five years imprisonment on each of eight separate courts, to be served concurrently.[12] On appeal, the Eighth Circuit Court of Appeals vacated the convictions on the ground that Naftalin's fraudulent conduct did not constitute a violation of section 17(a)(1) since the fraud did not occur in the "offer or sale" of securities as required by that section.[13] The position of the court was that the legislative purpose in enacting this particular section was "to protect investors from fraudulent practices in the sale of securities."[14] The court reasoned that the brokers with whom Naftalin placed his sell orders were not themselves purchasers of stock but were simply acting as agents of Naftalin to find purchas-

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[10] *Id.* at 771.

[11] The full text of section 17(a) reads as follows:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
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> (1) to employ any device, scheme, or artifice to defraud, or
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> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1976).

[12] *See* United States v. Naftalin, 579 F.2d 444, 445-46 (8th Cir. 1978). Criminal sanctions for willful violations of the Securities Act are recognized in § 24 of that Act. 15 U.S.C. § 77x (1976). This section provides that "[a]ny person who willfully violates any of the provisions of [the Act], or the rules and regulations promulgated by the Commission under authority thereof . . . shall upon conviction be fined not more than $10,000 or imprisoned not more than five years, or both." *Id.*

[13] 579 F.2d at 447, 449.

[14] *Id.* At 447.

ers willing to purchase his stock.[15]

The Supreme Court granted certiorari[16] and, in an opinion by Mr. Justice Brennan, reversed the decision of the court of appeals.[17] The Supreme Court believed that the court of appeals had given too narrow a construction to the language of section 17(a)(1)[18] and had adopted too restrictive an interpretation of Congress' intent in enacting the Securities Act of 1933.[19] Referring to the need for the fraud to occur "in the offer or sale" of securities, the Court remarked that "[t]he statutory terms, which Congress expressly intended to define broadly . . . are expansive enough to encompass the entire selling process, including the seller/agent transaction."[20] In regard to the purpose of Congress in enacting the Securities Act, while conceding that one of the primary aims was to protect investors from fraudulent practices in the sale and distribution of securities,[21] the Court pointed to other portions of the Act's legislative history which it felt showed that an additional purpose was to protect ethical business practices.[22] As the Court suggested, "the welfare of investors and financial intermediaries are inextricably linked—frauds perpetrated upon either business or investors can redound to the detriment of the other and to the economy as a whole."[23]

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[15] *Id.*

[16] 439 U.S. 1045 (1978).

[17] 441 U.S. at 771. The other Justices joined in Mr. Justice Brennan's opinion with the exception of Mr. Justice Powell, who did not participate in the consideration or decision of the case. *Id.* at 769.

[18] *Id.* at 773.

[19] *Id.* at 774-77.

[20] *Id.* at 773. Section 2(3) of the Securities Act defines the term "sale" as including "every contract of sale or disposition of a security or interest in a security, for value," and defines the term "offer" as including "every attempt or offer to dispose of . . . a security or interest in a security, for value." 15 U.S.C. § 77b(3). The Court remarked that "[t]his language does not require that the fraud occur in any particular phase of the selling transaction. At the very least, an order to a broker to sell securities is certainly an 'attempt to dispose' of them." 441 U.S. at 773. The Court also rejected an argument that because subsection (3) of the § 17(a) of the Securities Act talks about fraud "upon a purchaser" of securities, that phrase should be read into all three subsections. *Id.* at 773-74.

[21] 441 U.S. at 774.

[22] *Id.* at 775-76.

[23] *Id.* at 776. On remand, the Eighth Circuit Court of Appeals reinstated the conviction of Naftalin on the eight separate courts, rejecting Naftalin's argument that

The Supreme Court's broad and liberal construction of section 17(a) of the Securities Act may seem somewhat surprising in view of the restrictive interpretations the Court has regularly given the antifraud provisions of the securities acts since its decision in *Blue Chip Stamps v. Manor Drug Stores*.[24] The explanation for this apparent aberration no doubt lies at least in part in the fact that *Naftalin* involved a government criminal prosecution, whereas other cases involving more restrictive interpretations, such as *Blue Chip Stamps*, have considered private damage suits which posed the danger of a widely expanded class of plaintiffs using the federal courts.[25] *Naftalin* therefore may represent only an isolated exception to the otherwise restrictive trend in recent Supreme Court decisions. Nevertheless, as one commentator has pointed out, "rather than being discounted and ignored, *Naftalin* should emerge as a decision that attorneys would do well to remember,"[26] for, as he adds, "the decision provides the opportunity to rely on contemporary Supreme Court language when urging a broad interpretation of the federal securities laws."[27]

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he should have been convicted only on a single scheme to defraud. United States v. Naftalin, 606 F.2d 809, 810 (8th Cir. 1979). The court pointed out that even though there might have been a common fraud among Naftalin's sales, "courts have consistently held that each sale of a security may constitute a separate offense." *Id.*

[24] 421 U.S. 723 (1975). *See* Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977).

[25] The Court in *Naftalin* recognized this distinction when it said: "This case involves a criminal prosecution. The decision in *Blue Chip Stamps v. Manor Drug Stores* . . . which limited to purchasers or sellers the class of plaintiffs who may have private implied causes of action under Securities and Exchange Commission Rule 10b-5, is therefore inapplicable." 441 U.S. at 774 n.6.

[26] Steinberg, *Section 17(a) of the Securities Act of 1933 After Naftalin and Redington*, 68 GEO. L.J. 163, 164 (1979).

[27] *Id.* Another significant development to emerge from the Court's opinion in *Naftalin* was the willingness of the Court to recognize the application of § 17(a) of the Securities Act to conduct in the subsequent trading in securities as well as in the initial distribution of securities. 441 U.S. at 777-78. This has significance because it "subjects certain misconduct to the proscriptions and sanctions of both section 17(a) of the Securities Act and section 10(b) of the Exchange Act." Steinberg, *supra* note 26, at 172.

B. *Fraud by Brokers*

In another recent case, *Touche Ross & Co. v. Redington,*[28] the Supreme Court was called upon to decide whether a private civil remedy for damages can be implied under section 17(a) of the Securities Exchange Act of 1934.[29] The suit was brought on behalf of the customers of a securities brokerage firm against a firm of certified public accountants. These accountants had audited certain financial reports required to be filed by the brokerage firm under section 17(a); the reports, however, contained false information.[30]

The brokerage firm, Weis Securities, Inc., had retained Touche Ross & Co. to serve as its independent certified public accountant.[31] Touche Ross prepared for Weis the annual financial condition reports required to be filed with the SEC under section 17(a),[32] and also prepared responses to financial questionaires required by the New York Stock Exchange of its member firms.[33] Weis became insolvent and was placed in liquidation under the Securities Investor Protection Act.[34] The Securities Investor Protection Corporation (SIPC) and the trustee in liquidation brought suit in the United States District Court for the Southern District of New York against

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[28] 442 U.S. 560 (1979).

[29] 15 U.S.C. § 78q(a) (1976).

[30] 442 U.S. at 562.

[31] *Id.* at 563.

[32] The reporting requirement presently is contained in paragraph (a)(1) of § 17, the relevant portion of which reads as follows:

> Every . . . registered broker or dealer . . . shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this chapter.

15 U.S.C. § 78q(a)(1) (1976).

Under SEC rule 17a-5, every registered broker or dealer is required to file an annual report with the SEC audited by an independent public accountant. The accountant's report is required to state whether the audit was made in accordance with generally accepted auditing standards and whether the accountant reviewed the procedures followed for safeguarding securities. The rule further requires that there be attached to the report filed by the broker or dealer an oath or affirmation by the broker or dealer that to the best of his knowledge the information contained in the report is true and correct. 17 C.F.R. § 240.17a-5 (1979).

[33] 442 U.S. at 563-64.

[34] 15 U.S.C. § 78aaa-78lll (1976).

Touche Ross to recover damages. The suit was based on allegations that Touche Ross, due to an improper audit of the books and records of Weis, had failed to uncover a conspiracy by the officers of Weis to conceal substantial operating losses through falsifying the financial reports required to be filed with the regulatory authorities.[35] As a result of this dereliction on the part of Touche Ross, it was claimed that the true financial condition of Weis did not come to light until too late to prevent losses to Weis' customers.[36] The district court dismissed the complaint as failing to state a cause of action.[37] According to the court, section 17(a) was to be considered as in the nature of a bookkeeping provision that did not "create any rights in anybody."[38] The Court of Appeals for the Second Circuit reversed, holding that section 17(a) imposes a duty on accountants which can form the basis for an implied right of action in favor of a broker-dealer's customers.[39] The Supreme Court granted certiorari,[40] and, in an opinion by Mr. Justice Rehnquist, declined to accept the court of appeals' position that a private cause of action could be implied under section 17(a).[41]

Basing its opinion primarily on the statutory language of section 17(a), the Court concluded that there was no reason to infer that Congress intended to confer rights on private parties through the enactment of section 17(a).[42] Rather, as held

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[35] 442 U.S. at 565-66. The trustee sought to recover $51 million for itself and the customers of Weis. SIPC claimed $14 million either in its own right or by way of subrogation to claims paid on behalf of the customers of Weis. *Id.* at 566.

[36] *Id.*

[37] Touche Ross & Co. v. Redington, 428 F. Supp. 483, 491 (S.D.N.Y. 1977).

[38] *Id.* at 489.

[39] Touche Ross & Co. v. Redington, 592 F.2d 617 (2d Cir. 1978).

[40] 439 U.S. 979 (1978).

[41] 442 U.S. at 567.

[42] *Id.* at 569. The Court has frequently stressed the importance of statutory language in cases involving the scope and application of § 10(b) of the Securities Exchange Act and rule 10b-5 promulgated by the SEC thereunder. *See, e.g.,* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (rejecting the contention that rule 10b-5 covers internal corporate mismanagement not involving deceptive conduct); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (rejecting mere negligent conduct as sufficient to sustain a cause of action under rule 10b-5); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (upholding the purchaser-seller requirement as a prerequisite for standing to sue under rule 10b-5).

by the district court, section 17(a) should be considered a record keeping and reporting provision which, like similar provisions in other statutes, provides the appropriate regulatory authorities with the information needed by them to police compliance with the statutes and regulations under their jurisdiction.[43] As a further justification for refusing to imply a private remedy under section 17(a), the Court noted the presence of an express civil liability provision in section 18(a) of the Securities Exchange Act directed at false and misleading statements appearing in documents filed with the SEC.[44] Although this provision is available only to persons who have purchased or sold a security at a price which has been affected by false or misleading statements and therefore could not have been used by SIPC or the liquidation trustee for the benefit of the customers of Weis in *Redington*,[45] the Court refused to accept the argument that a cause of action in favor of such customers should accordingly be inferred under section 17(a), saying that "we are extremely reluctant to imply a cause of action in § 17(a) that is significantly broader than the remedy that Congress chose to provide."[46]

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[43] 442 U.S. at 569.

[44] *Id.* at 572.

[45] *See* 15 U.S.C. § 78r (1976). Paragraph (a) of this section provides, in part:

> Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder . . . which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. . . .

15 U.S.C. § 78r(a) (1976).

[46] 442 U.S. at 574. Mr. Justice Marshall wrote a dissenting opinion, arguing that a straightforward application of the four factors stressed by the Court in Cort v. Ash, 422 U.S. 66 (1975) for determining whether a private cause of action is implicit in a statute confirmed the existence of such a cause of action in *Redington*. The Court in *Cort* stated the four factors as follows:

> First, is the plaintiff "one of the class for whose *especial* benefit the statute was enacted," . . . that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? . . . Third, is it

The Court's narrow reading of the statutory language in *Redington* and the resulting restrictive attitude of the Court toward inferring a cause of action in favor of private parties under section 17(a) of the Securities Exchange Act is not surprising in view of the similarly restrictive attitude the Court has recently displayed in other securities litigation.[47] However, the decision does represent a further retreat from the more generous attitude regarding private causes of action the Court had earlier taken in *J. I. Case Co. v. Borak.*[48] In *Borak,* the Court readily found a basis for implying a private cause of action in favor of investors under section 14(a) of the Securities Exchange Act dealing with the regulation of proxy solici-

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> consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? . . . And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?

Id. at 78 (citations omitted).

Applying these four factors to *Redington,* Mr. Justice Marshall concluded that the brokerage firm customers could be considered the intended beneficiaries of the regulatory scheme; that there was no indication that Congress intended to restrict the remedies available under § 17; that a cause of action for damages would be consistent with the legislative scheme; and that enforcement of the reporting provisions of the Securities Exchange Act would not be considered a matter of traditional state concern. 442 U.S. at 580-83. In Marshall's view, "implying a private right of action would both facilitate the SEC's enforcement efforts and provide an incentive for accountants to perform their certification functions properly." *Id.* at 582. In his majority opinion, Mr. Justice Rehnquist, having found no language in the statute making conduct unlawful as to an identifiable class and having found no relevant legislative history pointing toward an intent on the part of Congress to create a private right of action, determined the inquiry should stop there without regard to the other two *Cort* factors. *Id.* at 576. In a similar vein, Mr. Justice Brennan, writing a separate concurring opinion, emphasized that "when the plaintiff is not 'one of the class for whose *especial* benefit the statute was enacted,' . . . and when there is also in the legislative history no 'indication of legislative intent, explicit or implicit . . . to create such a remedy,' . . . the remaining two *Cort* factors cannot by themselves be a basis for implying a right of action." *Id.* at 580 (citations omitted). Mr. Justice Powell took no part in the consideration of the case. *Id.*

[47] *See* Lowenfels, *supra* note 24, at 891-92.

[48] 377 U.S. 426 (1964). The Court struck another blow at *Borak* recently when, in Transamerica Mortgage Advisers, Inc. (TAMA) v. Lewis, 100 S. Ct. 242 (1979), the Court, in a 5-4 decision, refused to recognize an implied private action under § 206 of the Investment Advisers Act, which prohibits fraudulent or deceptive conduct on the part of investment advisers in their dealings with their clients. *See* 15 U.S.C. § 80b-6 (1976).

tations.[49] As to *Borak*, the Court in *Redington* said that to the extent its analysis in *Redington* differed from that of the Court in *Borak*, "it suffices to say that in a series of cases since *Borak* we have adhered to a stricter standard for the implication of private causes of action, and we follow that stricter standard today."[50]

C. *Materiality*

Litigation involving SEC rule 10b-5 continues to flow through the lower federal courts at a steady pace and cases in the Sixth Circuit dealing with this rule form no exception. Two recent cases decided by the Sixth Circuit underscore the importance of the materiality and scienter elements in rule 10b-5 litigation.

The first of these cases, *Toledo Trust Co. v. Nye*,[51] raised the issue of materiality in the context of a first-option stock transfer restriction contained in the bylaws of a closely-held corporation.[52] Henry T. Ritter, at the time of his death, owned 143 of the 930 outstanding shares of common stock in Lantana Flower Farms, Inc., a closely-held Florida corporation engaged in the commercial flower business.[53] Under Lantana's

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[49] In *Borak*, the Court had stressed the language of § 14(a) of the Securities Exchange Act which speaks of the Securities and Exchange Commission adopting such rules and regulations as might be "necessary or appropriate in the public interest *or for the protection of investors*." 15 U.S.C. § 78n(a) (1976) (emphasis added). The Court remarked that "[w]hile this language makes no specific reference to a private right of action, among its chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result." 377 U.S. at 432.

[50] 442 U.S. at 578. As to the outlook for implied rights of action as a result of *Redington* and other recent Supreme Court decisions, *see generally* Steinberg, *Implied Private Rights of Action Under Federal Law*, 55 NOTRE DAME L. 33 (1979).

[51] 588 F.2d 202 (6th Cir. 1978).

[52] Stock transfer restrictions can take a variety of forms and can be framed to operate in a variety of ways. *See* 2 F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE § 7.05 (2d ed. 1971). However, one of the more popular and useful of such restrictions is the first-option restriction which gives to the corporation or the other shareholders in the corporation (or perhaps both) the first opportunity to buy the shares of a shareholder before the shares are sold or transferred to a third party. *Id.* § 7.09. The legality of the first-option restriction has generally been upheld as not constituting an unreasonable restraint on the alienation of property. *See e.g.*, Lawson v. Household Fin. Corp., 152 A. 723 (Del. Ch. 1930).

[53] 588 F.2d at 203.

bylaws, Lantana was given the option to purchase the shares of a deceased shareholder within thirty days after death by paying the fair market value of the stock as of the end of the month immediately preceding the exercise of the option.[54] The bylaws specified that the fair market value was to consist either of the value agreed upon by the corporation and the shareholder, or if they were unable to agree upon such value, the higher of the book value of such shares as shown by the balance sheet of the corporation or the value determined by multiplying the average earnings per share for the last three fiscal years by a factor of ten.[55] Negotiations between plaintiff, The Toledo Trust Co., as executor of Ritter's estate, and William Nye, president of Lantana, resulted in an offer of $15,000 for Ritter's stock (approximately $104.90 per share) which plaintiff accepted.[56] At the same time these negotiations were taking place, Nye was consulting with representatives of United Fruit Co. concerning a possible takeover of Lantana by United.[57] These consultations ultimately led to a sale of all outstanding Lantana stock to United at a per share price which was roughly thirty times the per share price which Lantana had previously paid plaintiff for Ritter's shares.[58] Upon learning of the United transaction, plaintiff brought suit in the United States District Court for the Northern District of Ohio under section 10(b) of the Securities Exchange Act of 1934,[59] and rule 10b-5,[60] seeking damages against Lantana,

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[54] *Id.* at 210-11.

[55] *Id.* at 211.

[56] *Id.* at 204-05.

[57] *Id.* At 205.

[58] *Id.*

[59] 15 U.S.C. § 78j(b) (1976). The section reads:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors.

Id.

United, Nye, and the other individual shareholders of Lantana.[61] The district court held that the defendants had a duty to disclose to the plaintiff the information they possessed concerning United's takeover at the time of the closing of the option to purchase Ritter's shares and had violated rule 10b-5 by failing to do so.[62] The court entered a judgment for the plaintiff in the amount of $407,840.[63]

The Sixth Circuit reversed the district court's decision on the ground that one of the essential elements to a rule 10b-5 claim, that of materiality, was missing in the case.[64] There can be no liability under rule 10b-5, stated the court, "in the absence of misrepresentation or nondisclosure of a material fact."[65] Pointing to the contractual obligation placed on Lantana under the bylaw option to purchase Ritter's shares at a price based on fair market value as of the end of the month immediately preceding the exercise of the option, the court concluded that the nondisclosed information regarding the United negotiations could not have been material to the plaintiff since "[i]t was contractually bound to sell Ritter's shares to Lantana at an established price as of a certain date, which date was long before the nondisclosed information even existed."[66]

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[60] 17 C.F.R. § 240.10b-5 (1979). The full text of the rule reads as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud;
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

[61] Toledo Trust Co. v. Nye, 426 F. Supp. 908 (N.D. Ohio 1977).

[62] *Id.* at 913.

[63] *Id.* at 915. To this sum the district court added $75,000 for attorney's fees and expenses as well as interest on both amounts. *Id.*

[64] 588 F.2d at 206. The Sixth Circuit also reversed the finding of the district court that plaintiff's claim could be supported on the basis of common law fraud and breach of fiduciary duty. *Id.* at 209.

[65] *Id.* at 206.

[66] *Id.* The court compared a similar result reached by the Eighth Circuit Court

In addition to the emphasis placed by the court of appeals in *Nye* on the element of materiality, the court urged caution in allowing federal law to interfere with stock restrictions contained in the bylaws of closely-held corporations absent a clear congressional mandate.[67] Citing *Santa Fe Industries Inc. v. Green,*[68] in which the Supreme Court stressed that rule 10b-5 should not be extended to matters of internal corporate mismanagement traditionally regulated by state law,[69] the court remarked as to the stock restriction before it that "[w]hether or not such stock options are 'fair' or wise as a policy matter is a question of state law which is beyond the power of this court to determine."[70] Accordingly, the court concluded:

> While it appears, in retrospect, that Ritter made a bad bargain, it is not the function of the federal courts to relieve him of that responsibility. It may be that the fortuity of Ritter's death arbitrarily cut him (or his estate) out of a considerable sum of money, but that is the agreement he made and there is no federal policy against enforcement of it.[71]

D. *Scienter*

The second opinion from the Sixth Circuit Court of Appeals to be discussed: *Mansbach v. Prescott, Ball & Turben,*[72] involved the question whether allegations of reckless conduct are sufficient to satisfy the scienter requirement enunciated

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of Appeals based on lack of reliance instead of lack of materiality. St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 562 F.2d 1040 (8th Cir. 1977), *cert. denied,* 435 U.S. 925 (1978). The Sixth Circuit chose materiality instead of reliance as the proper basis on which to decide cases of this kind in view of the Supreme Court's position in *Affiliated Ute Citizens* that in cases of nondisclosure "positive proof of reliance is not a prerequisite to recovery" in rule 10b-5 cases as long as the withheld information is material. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972). If the nondisclosed information is considered material, the Sixth Circuit in *Nye* felt that of the two modes of analysis—materiality and reliance—materiality is preferable in view of *Affiliated Ute Citizens.* 588 F.2d at 207 n.21.

[67] 588 F.2d at 209.

[68] 430 U.S. 462 (1977).

[69] *Id.* at 478-80.

[70] 588 F.2d at 209.

[71] *Id.* at 210.

[72] 598 F.2d 1017 (6th Cir. 1979).

by the United States Supreme Court in *Ernst & Ernst v. Hochfelder*[73] for damage actions brought under section 10(b) and rule 10b-5.

The Supreme Court in *Hochfelder* rejected the position that "negligent conduct alone" is sufficient to establish a private cause of action for damages under section 10(b) and rule 10b-5,[74] and held that no such action could be maintained "in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud."[75] In elaborating on the scienter requirement it was establishing, the Court stated that the term "scienter" was being used by it to refer to "a mental state embracing intent to deceive, manipulate, or defraud."[76] From this statement, it might have appeared that nothing short of a specific mental state evidencing evil intent would be sufficient to satisfy the scienter requirement, but the Court qualified its statement about "intent to deceive" by conceding that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act."[77] The court specifically left open "the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5."[78]

The *Mansbach* case involved allegations by an investor against a securities brokerage firm charging the firm, through its agent and employee, with improperly carrying out the instructions of the investor as to trading in certain corporate options.[79] The United States District Court for the Western District of Kentucky had dismissed this portion of the complaint[80] on the ground that it alleged no more than "negligent

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[73] 425 U.S. 185 (1976).

[74] *Id.* at 214.

[75] *Id.* at 193.

[76] *Id.* at 193 n.12.

[77] *Id.*

[78] *Id.*

[79] 598 F.2d at 1021.

[80] The complaint contained three counts. Count I stated the allegations concerning the option transaction. *Id.* A second count, Count II, related to a complaint by the investor, Mansbach, as to the refusal of the brokerage firm, Prescott, Ball & Turben, to return certain corporate bonds which Mansbach had delivered to the firm as collateral for the anticipated option transactions. *Id.* The brokerage firm contended that a pledge of corporate bonds was not a "purchase or sale" of securities as

clerical errors and innocent incompetence" on the part of the brokerage firm.[81] Differing with the district court as to the nature of the allegations and finding what it considered to be allegations of "recklessness and gross negligence,"[82] the Sixth Circuit followed the position already adopted in other federal circuits[83] that "recklessness is a sufficiently culpable state of mind for liability under § 10(b) and Rule 10b-5."[84] In support of its position the court referred to the acceptance of recklessness as sufficient to satisfy the scienter requirement for fraud at common law,[85] treating the section 10(b) and rule 10b-5

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required by § 10(b) and rule 10b-5 so as to give Mansbach standing to sue. *Id.* at 1028. The lower federal courts are divided over the question whether a pledge can be considered a "purchase or sale" under § 10(b) and rule 10b-5. The Second Circuit Court of Appeals has taken the position that a pledge can be treated as a "purchase or sale" within these provisions. *See* Mallis v. Fed. Deposit Ins. Corp., 568 F.2d 824 (2d Cir. 1977). On the other hand, the Fifth and Seventh Circuit Courts of Appeals have taken the contrary position. *See* Lincoln Nat'l Bank v. Herber, 604 F.2d 1038 (7th Cir. 1979); National Bank of Commerce v. All Am. Assurance Co., 583 F.2d 1295 (5th Cir. 1978). The Supreme Court had an opportunity to settle this issue when it granted certiorari in the *Mallis* case but lost that opportunity when it reversed its position and dismissed certiorari on procedural grounds. *See* Bankers Trust Co. v. Mallis, 435 U.S. 381, *reh. denied,* 413 U.S. 915 (1978). Noting the split of authority in the other federal circuits as to the nature of a pledge, the Sixth Circuit in *Mansbach* decided to follow "those cases holding that a pledge is a 'purchase or sale.' " 598 F.2d at 1028.

[81] 598 F.2d at 1022.

[82] *Id.* at 1026.

[83] *See* Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir.), *cert. denied,* 439 U.S. 1039 (1978); Coleco Indus., Inc. v. Berman, 567 F.2 569, 574 (3d Cir. 1977), *cert. denied,* 439 U.S. 830, *reh. denied,* 439 U.S. 998 (1978); First Va. Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied,* 435 U.S. 952 (1978); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1039-40 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977).

[84] 598 F.2d at 1023.

[85] A similar analogy was stressed by the Second Circuit Court of Appeals in Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), *cert. denied,* 439 U.S. 1039 (1978), in which the court said:

> It is unquestionable that the common law has served as an interpretive source of securities law concepts. . . . The common law tort of fraud has adopted a recklessness standard as one means of satisfying the requisite intent element of that cause of action. Similarly, securities law cases have recognized that recklessness may serve as a surrogate concept for willful fraud.

Id. at 45-46 (citations omitted). *See generally,* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 107, at 700-01 (4th ed. 1971); RESTATEMENT OF TORTS § 526(b), Comment e claim as "essentially the federal securities law counterpart to the common law tort of fraud."[86] The court also noted the problem of proof that would arise if a plaintiff were required to sustain the burden of showing an "actual subjective intent to defraud" on the part of the defendant.[87] Falling back on expressions in earlier Supreme Court decisions that section 10(b) and rule 10b-5 should be given a liberal construction in order to effectuate the underlying policies of the securities laws,[88] the court concluded that "we should construe the § 10(b)/Rule 10b-5 claim no more narrowly than required by *Hochfelder.*"[89]

While the position of the court that section 10(b) and rule 10b-5 are to be given a liberal construction may be open to question in view of the more recent Supreme Court decisions,[90] it does seem reasonable to treat reckless conduct as within the framework of "intentional" conduct as used by the Supreme Court in *Hochfelder*. As Judge Friendly observed in his concurring opinion in the well-known *Texas Gulf Sulphur* case,[91] where he was dealing with alleged misstatements appearing in a corporate press release, there is a difference in "the award of damages for merely negligent misstatement, as distinguished from the kind of recklessness that is equivalent to wilful fraud."[92]

(1938).

[86] 598 F.2d at 1024.

[87] *Id.* at 1025. In *Rolf*, the Second Circuit commented on the proof problem that insistence on an intentional standard of conduct might impose as follows:

> A final basis for applying a recklessness standard in certain instances rests perhaps on the practical problem of proof in private enforcement under the securities laws. Proof of a defendant's knowledge or intent will often be inferential . . . and cases thus of necessity cast in terms of recklessness. To require in all types of 10b-5 cases that a factfinder must find a specific intent to deceive or defraud would for all intents and purposes disembowel the private cause of action under § 10(b).

570 F.2d at 47 (citations omitted).

[88] *See e.g.*, Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971)("Section 10(b) must be read flexibly, not technically and restrictively.").

[89] 598 F.2d at 1024-25.

[90] *See* Whitaker & Rotek, *The Supreme Court and the Counter-Revolution in Securities Regulation*, 30 ALA. L. REV. 335 (1979).

[91] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), *reh. denied*, 404 U.S. 1064 (1972).

[92] *Id.* at 868. The commentators also seem to be in general agreement that reck-

II. STATE CORPORATION LAW

A. *Derivative Suits*

The proper dichotomy between state and federal law in the enforcement of the federal securities acts and other federal legislation has been a continuing problem for the federal courts.[93] The Supreme Court, however, has made it clear that corporations are to be considered "creatures of state law,"[94] and that, except where federal law expressly otherwise requires, state law is to govern the internal affairs of the corporation.[95] This attitude on the part of the Court was underscored recently in the case of *Burks v. Lasker.*[96] In *Burks,* the Court considered the question whether a group of disinterested directors of an investment company could terminate a shareholders' derivative suit brought against other directors of the company under the Investment Company Act[97] and the Investment Advisers Act.[98]

Certain shareholders of Fundamental Investors, Inc., a registered investment company, brought a derivative suit in the United States District Court for the Southern District of New York against several members of its board of directors and its investment adviser, Anchor Corporation. The suit charged the defendants with violating their fiduciary duties

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lessness should be sufficient to meet the scienter requirement of *Hochfelder. See e.g.,* Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5:* Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213 (1977), in which the author stated:

> Because the inclusion of recklessness within the definition of scienter would not greatly expand the group of defendants whose conduct falls within the ambit of rule 10b-5 culpability, but would significantly increase the chances of punishing those persons whose conduct, if provable in court, would fall within any definition of reprehensible securities fraud, the balance between protecting investors and allowing broad scope to valid commercial activities must tip in favor of including recklessness.

Id. at 240.

[93] *See Proceedings, The Airlie House Symposium, An In-Depth Analysis of the Federal and State Roles in Regulating Corporation Management,* 31 BUS. LAW. 861 (Special Issue Feb. 1976).

[94] Cort v. Ash, 422 U.S. 66, 84 (1975).

[95] *Id.*

[96] 441 U.S. 471 (1979).

[97] 15 U.S.C. § 80a-1 to 80a-52 (1976 & Supp. II 1978).

[98] 15 U.S.C. § 80b-1 to 80b-21 (1976 & Supp. II 1978).

under the Investment Company Act and the Investment Advisers Act in connection with a $20 million investment in Penn Central Transportation Company commercial paper prior to the bankruptcy of that company.[99] The board of directors of Fundamental met to consider the derivative suit and decided to refer the matter of the company's position regarding the suit to the five members of the board who were neither named as defendants in the suit nor affiliated with the investment adviser.[100] These five "disinterested" directors concluded that the prosecution of the action was not in the best interest of the shareholders of Fundamental and that dismissal of the suit should be sought.[101] The district court took the position that under the "business judgment rule,"[102] the determination of the five independent minority directors should be respected, so long as they were shown to be truly independent and disinterested.[103] The court granted discovery on the issue of independence,[104] and after discovery, granted the motion to dismiss.[105] The Court of Appeals for the Second Circuit reversed the district court,[106] finding nothing in the legislation regulating investment companies to suggest that disinterested directors of an investment company have power "to foreclose the continuation of nonfrivolous litigation

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[99] 441 U.S. at 473, n.3.

[100] *Id.* at 474. There were a total of eleven directors on the board. Five of the remaining six directors were defendants in the suit and the sixth was a director of Anchor Corporation, the investment adviser. *Id.* at 474 n.4.

[101] *Id.* at 474.

[102] The "business judgment rule" is a doctrine which has been invoked repeatedly by state courts to insulate officers and directors from liability for losses to the corporation resulting from errors of judgment as opposed to negligent conduct in managing corporate affairs. *See* H. HENN, LAW OF CORPORATIONS § 242 (2d ed. 1970).

[103] Lasker v. Burks, 404 F. Supp. 1172 (S.D.N.Y. 1975). In support of its result, the court stated:

> In the Court's view, the independent minority of directors had the power to decide what position the Fund should take. This is consistent with the policy that a corporation be given the opportunity to control a lawsuit brought on its behalf, that the Board be allowed to exercise its normal functions in running the corporation, and that a derivative suit should be resorted to as a last alternative.

Id. at 1179.

[104] *Id.* at 1180.

[105] Lasker v. Burks, 426 F. Supp. 844, 853 (S.D.N.Y. 1977).

[106] Burks v. Lasker, 567 F.2d 1208 (2d Cir. 1978).

brought by shareholders against majority directors for breach of their fiduciary duties."[107]

Upon certiorari,[108] the Supreme Court disagreed with the position adopted by the court of appeals. Treating state law as the source of the powers of corporate directors and considering the role of federal law to be primarily regulatory in nature,[109] the Court found nothing in the congressional regulation of investment companies to justify "a flat rule that directors may never terminate non-frivolous derivative actions involving co-directors."[110] Therefore, according to the Court, the initial inquiry for a federal court in cases of this kind should be to determine whether state law permits disinterested directors to terminate derivative suits.[111] The next inquiry would be to determine whether the state rule was consistent with the policies of the Investment Company Act and the Investment Advisers Act.[112] Remanding the case for further proceedings consistent with its opinion, the Court said:

> We hold today that federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the ICA and IAA. Moreover, we hold that Congress did not require that States, or federal courts, absolutely forbid director termination of all nonfrivolous

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[107] *Id.* at 1212. The court remarked:

> In the ordinary routine of running an investment trust, the disinterested directors must constantly deal with interested directors in a spirit of accommodation. Indeed, they are compelled for the most part to rely on the information and expert advice provided by the adviser and the majority directors. The continued service of the statutorily disinterested directors . . . depends almost entirely on the establishment of satisfactory working arrangements between them and the majority responsible for their selection. It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned.

Id.

[108] 439 U.S. 816 (1978).

[109] 441 U.S. at 478.

[110] *Id.* at 481-82. For a general discussion of the duties possessed by directors of investment companies see Radmer, *Duties of the Directors of Investment Companies*, 3 J. CORP. L. 61 (1977).

[111] 441 U.S. at 480.

[112] *Id.*

actions.[113]

Whatever influence this decision may ultimately have on the attitude of the lower federal courts in future litigation involving the "business judgment rule,"[114] it has been suggested that it may well produce a "cooling trend in the courts with respect to the rights of private parties who claim to have been burned in the market place,"[115] even if it does not constitute an "instrument of death" for the shareholders' derivative action.[116]

B. *Insider Trading*

Another aspect of corporation law involving the interrelationship between federal and state law is that involving insider trading by corporate officers and directors in the stock of their corporation.[117] In fact, it was the prevalence of this prac-

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[113] *Id.* at 486. Mr. Justice Brennan wrote the opinion for the majority of the Court. In a separate concurring opinion, joined by Mr. Justice Powell, Mr. Justice Stewart expressed the view that since both the Investment Company Act and the Investment Advisers Act are silent on whether a shareholders' derivative suit may be terminated by disinterested directors, there is no reason to assume that state law will conflict with federal policy if the applicable state law permits disinterested directors to do this under the "business judgment rule." Therefore, as he viewed it, on remand the only issue should be "whether the state law here applicable recognizes this generally accepted principle and thereby empowers the directors to terminate this stockholder suit." *Id.* at 487. Mr. Justice Blackmun, concurring in the Court's opinion, rejected the absolutist position expressed by Mr. Justice Stewart, on the ground that "a situation could very well exist where state law conflicts with federal policy." *Id.* Mr. Justice Rehnquist took no part in the consideration of the case. *Id.* at 486.

[114] For recent applications of the *Burks* analysis, see Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), *cert. denied,* 48 U.S.L.W. 3432 (U.S. Jan. 8, 1980) (termination of shareholders' derivative action under Delaware business judgment rule by "Special Litigation Committee" of outside board members did not impinge on policies underlying the reporting and proxy provisions of the Securities Exchange Act); Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979) (dismissal of shareholders' derivative action by "special litigation committee" of disinterested directors under California business judgment rule not in conflict with underlying policies of § 10(b) of Securities Exchange Act and rule 10b-5 or the disclosure requirements relating to proxy solicitations under § 14(a) of the Securities Exchange Act).

[115] SEC. REG. & L. REP. (BNA) No. 530, A-16 (Nov. 28, 1979) (report of panel discussion at Practicing Law Institute's Eleventh Annual Institute on Securities Regulation).

[116] *Id.* at A-18.

[117] *See* Ratner, *Federal and State Roles in the Regulation of Insider Trading,* 31 BUS. LAW. 947 (Special Issue Feb. 1976).

tice that led to the adoption of rule 10b-5 by the Securities and Exchange Commission in 1942.[118] At that time, state law dealing with insider trading abuses was uneven and unsettled.[119] Furthermore, such law as did exist related to suits against officers and directors by shareholders and did not extend to suits by or on behalf of the corporation to recover profits made by officers and directors through trading on inside information.[120]

The first recognition of a corporate suit to recover insider profits under state law came in 1969 in *Diamond v. Oreamuno.*[121] In that case, the New York Court of Appeals held that a shareholder's derivative suit could be maintained on behalf of a corporation to recover profits made by two of its officers and directors through use of inside information in selling shares of the corporation's stock owned by them.[122]

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[118] *See Proceedings, Conference on Codification of the Federal Securities Laws,* 22 BUS. LAW. 793, 922 (1967).

[119] The traditional viewpoint, referred to as the majority rule, has been that the fiduciary obligations of corporate officers and directors run to the corporation and not to individual shareholders in the corporation. *See, e.g.,* Carpenter v. Danforth, 52 Barb. 581 (N.Y. Sup. Ct. 1868). Some jurisdictions have softened the operation of the majority rule by requiring disclosure of information to shareholders where "special facts" exist making it unfair to permit arms-length dealings between corporate officials and shareholders. The "special facts" doctrine had its origin in Strong v. Repide, 213 U.S. 419 (1909). A few jurisdictions apply a strict fiduciary obligation of disclosure when insiders purchase stock from individual shareholders. *See, e.g.,* Hotchkiss v. Fischer, 16 P.2d 531 (Kan. 1932). *See generally* 3 L. LOSS, SECURITIES REGULATION 1446-48 (1961).

[120] *See* Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares,* 46 CORNELL L.Q. 53 (1960).

[121] 248 N.E.2d 910 (N.Y. 1969). A previous Delaware case, Brophy v. Cities Service Co., 70 A.2d 5 (Del. Ch. 1949), had recognized a derivative action on behalf of a corporation to recover profits made by an employee (confidential secretary to one of the directors) as the result of trading in the corporation's stock. However, at the time the employee made his purchases of the corporation's stock, the employee believed that the corporation was also considering entering the market to make similar purchases and the case therefore could be considered more in the nature of violation of the employee's duty of loyalty when trading in competition with the corporation's planned market activity. *See* Note, *Corporations—Common Law Liabilities for Insider Trading,* 23 SW. L.J. 921, 924 (1969). It might also be possible to consider the employee's trading activity in *Brophy* as a violation of the corporate opportunity doctrine. For a discussion of the corporate opportunity doctrine as it relates to insider trading, see Slaughter, *The Corporate Opportunity Doctrine,* 18 SW. L.J. 96, 107 (1964).

[122] The two executive officers possessed information that there was to be a sharp

Judge Fuld, writing for the court, treated the inside information possessed by the defendant directors as in the nature of a corporate asset which, as fiduciaries, they were not entitled to appropriate for their own benefit.[123]

Subsequently, the Second Circuit Court of Appeals, in *Schein v. Chasen*,[124] extended the *Diamond* rule to third parties (tippees) misusing inside information passed on to them through the president of a Florida based corporation.[125] In his opinion for the court, Judge Waterman looked first to Florida law, but finding none applicable assumed that the Florida Supreme Court, if called upon to decide the question, would follow the lead of *Diamond*.[126] He said that viewing the case as the Florida court would probably view it, the "stretch" of *Diamond* should reach the defendants in the Florida case.[127] The

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decrease in the earnings of the corporation. Before the information was made public, the officers sold 56,500 shares of the corporation's stock which they owned at the then current market price of $28 a share. After the announcement of the drop in earnings, the market price of the stock fell from $28 per share to $11 per share. The officers thereby made a profit of $800,000 by selling their shares prior to the public announcement. The suit took the form of a derivative action to have the officers account to the corporation for this profit. 248 N.E.2d at 911.

[123] *Id.* at 912. Although Judge Fuld's corporate asset theory eliminated the need for specific allegations of damage to the corporations, he nevertheless suggested that insider trading could be considered as resulting in harm to the corporation because of the tarnished public image such insider trading might produce. *Id.*

[124] 478 F.2d 817 (2d Cir. 1973).

[125] The allegations in the complaint were that Chasen, the president and chief operating officer of Lum's Inc., had informed Simon, a stockbroker employed by Lehman Brothers, of an anticipated drop in the earnings of Lum's. It was charged that Simon then had passed the information on to the portfolio managers of two mutual funds who in turn directed the funds to sell their entire stockholdings in Lum's. By selling the Lum's shares before the earnings information was made public, it was claimed that the funds received $3.50 per share more for the stock than they otherwise would have received. *Id.* at 819-21. The United States District Court for the Southern District of New York had dismissed the suit as to the third party defendants on the ground that the *Diamond* holding did not extend beyond corporate officials to third parties. Gildenhorn v. Lum's, Inc., 335 F. Supp. 329, 334 (S.D.N.Y. 1971). For further background to the *Lum's* litigation, see SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973).

[126] 478 F.2d at 821.

[127] *Id.* at 822. Treating Lehman Brothers and the mutual funds as co-venturers with Schein in his breach of duty, Judge Waterman said:

> Moreover, in the light of the corporate interest which the *Diamond* rule is designed to protect, it is immaterial to the preservation of that interest whether the director trades on his own account in the corporation's stock or

defendants sought review of the Second Circuit decision by the United States Supreme Court on the ground that the appellate court should have availed itself of the Florida certification procedure and submitted the question to the Florida Supreme Court for a definitive ruling.[128] The United States Supreme Court granted certiorari on the certification issue,[129] and in an opinion by Mr. Justice Douglas, remanded the case to the court of appeals for reconsideration of the question whether the state law issue should have been certified to the Florida Supreme Court.[130] On remand, the issue of third party

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> whether he passes on the information to outsiders who then trade in the corporation's stock. In either event, so long as the director is involved, the prestige and good will of the corporation may be tarnished by the public revelation that the director has been involved in unethical conduct. . . . Accordingly, it would be self-defeating to limit the reach of *Diamond* to directors and officers of the injured corporation who have so acted while permitting third-party co-venturers of theirs to escape liability to the corporation.

Id. at 822-23.

[128] *See* FLA. STAT. ANN. § 25.031 (West 1974). The Florida certified question statute provides:

> The supreme court of this state may, by rule of court, provide that, when it shall appear to the supreme court of the United States, to any circuit court of appeals of the United States, or to the court of appeals of the District of Columbia, that there are involved in any proceeding before it questions or propositions of the laws of this state, which are determinative of the said cause, and there are no clear controlling precedents in the decisions of the supreme court of this state, such federal appellate court may certify such questions or propositions of the laws of this state to the supreme court of this state for instructions concerning such questions or propositions of state law, which certificate the supreme court of this state, by written opinion, may answer.

The Supreme Court of Florida has implemented this statutory authority by adoption of FLA. APP. R. 4.61. The Supreme Court of Kentucky adopted a similar certification rule for Kentucky, effective September 1, 1978. *See* KY. R. CIV. P. 76.37. In his dissenting opinion in *Schein v. Chasen,* Judge Kaufman questioned the desirability of deciding a novel question of Florida state law without giving the Florida Supreme Court an opportunity to provide an authoritative answer under the Florida certification procedure. 478 F.2d at 828-29.

[129] Lehman Brothers v. Schein, 414 U.S. 1062 (1973).

[130] Lehman Brothers v. Schein, 416 U.S. 386 (1974). After noting that resort to the certification procedure was not obligatory, Mr. Justice Douglas commented as to the situation in *Schein:*

> Here resort to it would seem particularly appropriate in view of the novelty of the question and the great unsettlement of Florida law, Florida being a distant State. When federal judges in New York attempt to predict

liability for trading on inside information was submitted by the court of appeals to the Florida Supreme Court, which answered by rejecting both the *Diamond* rule and its expansion to cover third parties.[131]

This rejection of *Diamond* was reinforced by a recent decision of the Seventh Circuit Court of Appeals in *Freeman v. Decio*,[132] applying Indiana law. After an extensive review of the *Diamond* opinion, which it characterized as an example of "judicial securities regulation,"[133] and an analysis of the existing Indiana law on insider trading,[134] the court concluded

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> uncertain Florida law, they act, as we have referred to ourselves on this Court in matters of state law, as "outsiders" lacking the common exposure to local law which comes from sitting in the jurisdiction.

Id. at 391.

[131] Schein v. Chasen, 313 So.2d 739 (Fla. 1975). In rejecting Judge Waterman's reasoning in the Second Circuit opinion, the Florida Supreme Court said:

> Not only will we not give the unprecedented expansive reading to *Diamond* sought by appellants but furthermore, we do not choose to adopt the innovative ruling of the New York Court of Appeals in *Diamond* . . . . We adhere to previous precedent established by the courts in this state that actual damage to the corporation must be alleged in the complaint to substantiate a stockholders' derivative action.

Id. at 746.

Judge Kaufman had foreshadowed the result reached by the Florida Supreme Court in his dissenting opinion in *Schein* when the case was first before the Second Circuit. Disagreeing with Judge Waterman, he questioned liability "founded on the conclusion of two federal judges that the Florida Supreme Court, if the instant case was before it, would look to a New York decision and, in addition, would give an unprecedented expansive reading to that case." 478 F.2d at 828.

On return of the case, the Second Circuit affirmed the original decision of the district court dismissing the suit. Schein v. Chasen, 519 F.2d 453 (2d Cir. 1975) (*per curiam*).

[132] 584 F.2d 186 (7th Cir. 1978). The suit was brought by Freeman, a shareholder in Skyline Corporation, against Decio, chairman of the board of directors of Skyline, and other directors of the corporation, charging that they had sold Skyline stock on the basis of material inside information. One of the charges covered sales made during fiscal quarters ending May 31, 1972, and August 31, 1972, when it was claimed the financial reports for those periods understated material costs and overstated earnings. A second charge claimed that during the quarter ending November 30, 1972, and up to December 22, 1972, Decio and another director made sales of Skyline stock with knowledge that reported earnings for the November 30 quarter would decline. *Id.* at 187.

[133] *Id.* at 196.

[134] Noting the Indiana Supreme Court holding in Board of Comm'rs of Tippecanoe Co. v. Reynolds, 44 Ind. 509 (1873), that a director owes no fiduciary duty to a shareholder in buying his stock, the court remarked that "it seems somewhat unlikely

that "were the issue to be presented to the Indiana courts at the present time, they would most likely join the Florida Supreme Court in refusing to adopt the New York Court's innovative ruling."[135]

Thus, despite Judge Fuld's observation in *Diamond* that "[t]he primary source of the law in this area ever remains that of the State which created the corporation,"[136] if the Florida attitude toward corporate recovery of insider trading profits under state law should prevail, state law will have lost an opportunity to assume a more dominant role in policy insider trading activity.[137] Furthermore, any such failure by state law to assume such a role could leave an unfortunate gap in the law pertaining to insider trading since such corporate suits at the federal level would appear limited to the recovery of short-swing profits under section 16(b) of the Securities Exchange Act.[138] It is true the SEC has been successful in bringing about the disgorgement of profits as ancillary relief in in-

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that a common law jurisdiction not directly protecting a selling shareholder from insider trading would go on to create a cause of action in favor of the corporation." 584 F.2d at 196. For a commentary on Indiana law as reflected in *Reynolds*, suggesting that in view of "[t]he realities of modern business practices," that case "should be overruled," *see* Ryan, *Should Tippecanoe County Comm'rs v. Reynolds Be Overruled?* 16 IND. L.J. 563, 574 (1941).

[135] 584 F.2d at 196. As an alternative ground for its decision, the court agreed with the district court that there was no factual basis for the plaintiff's claim. *Id.* at 196-200. The court also indicated that had they not agreed with the district court's conclusion that there was no factual basis for plaintiff's allegations of insider trading, they would have seriously considered use of the Indiana certified question statute. *Id.* at 189 n.8.

[136] 248 N.E.2d at 915.

[137] Although there has been some discussion among commentators as to the cost-efficiency of attempting to police insider trading, the general consensus seems to be in favor of discouraging such activity. *See* W. PLAINTER, FEDERAL REGULATION OF INSIDER TRADING (1968). This attitude was reflected by Judge Waterman in *Schein v. Chasen* when he spoke of the desirability of "tightening the law of insider trading" and the "prophylactic effect" that *Diamond* had in "providing a disincentive to insider trading." 478 F.2d at 823.

[138] 15 U.S.C. § 78p(b) (1976). Under the provisions of this section a suit can be brought by or on behalf of a corporation to recover profits realized by a director, officer, or beneficial owner of the corporation's stock, resulting from a purchase and sale, or sale and purchase, of the corporation's stock within a period of six months. *Id.* A beneficial owner is defined as any person who is directly or indirectly the beneficial owner of more than 10% of any class of equity security issued by the corporation. 15 U.S.C. § 78p(a) (1976).

junctive suits under rule 10b-5,[139] but it is no doubt unrealistic to assume that the Commission will seek such relief in every case in which it discovers illegal insider trading activity.[140] Corporate suits of this kind under rule 10b-5 also appear precluded because of the purchser-seller standing requirement imposed on rule 10b-5 plaintiffs by the Supreme Court of the United States in the *Blue Chip Stamps* case.[141]

Accordingly, as Judge Fuld suggested in upholding corporate recovery in *Diamond,* "[t]here is ample room in a situation such as here presented for a 'private Attorney General' to come forward and enforce proper behavior on the part of corporate officials through the medium of the derivative action brought in the name of the corporation."[142] For, as he said, "[o]nly by sanctioning such a cause of action will there be any effective method to prevent the type of abuse of corporate office complained of [in cases like *Diamond*]."[143]

C. *Shareholder Agreements*

Turning to more traditional areas of state corporation law, a recent decision by the Supreme Court of North Carolina, *Blount v. Taft,*[144] illustrates the possible ramifications of agreements among shareholders of a closely-held corporation relating to the structure and management of the business when the agreement is reflected in the charter or bylaws of the corporation.[145]

In *Blount,* the shareholders, representing three family factions (the Blounts, the Tafts, and the McGowans), unani-

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[139] SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), *cert. denied, sub nom* Holyk v. SEC, 404 U.S. 1005 (1971).

[140] *See* Ratner, *supra* note 117, at 954.

[141] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[142] 248 N.E.2d at 915.

[143] *Id.* The individual suit by private investors damaged in face-to-face dealings as the result of insider trading is, of course, still available at the federal level under rule 10b-5, but the availability of similar suits by private investors where the trading has occurred on the anonymous public market remains in doubt. *Compare* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974), *with* Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053 (1977).

[144] 246 S.E.2d 763 (N.C. 1978).

[145] *See* 1 F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE § 3.79 (2d ed. 1971).

mously adopted a set of bylaws which provided that the board of directors could, by majority vote, designate an executive committee consisting of one member from each of the three families.[146] It was further provided that the executive committee so appointed should have the exclusive authority by unanimous vote to select the employees of the corporation.[147] Several years later, as a result of family differences, the board of directors through majority vote, as provided by the bylaws, amended the bylaws so as to delete these provisions.[148] A new bylaw was adopted providing for appointment by a majority of the board of directors of an executive committee composed of two or more directors.[149] A new executive committee was appointed pursuant to this provision consisting of three members who represented each of the family factions.[150] One of the family groups (the Blounts) which was at odds with the other two family groups (the Taft and McGowan families) objected

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[146] 246 S.E.2d at 766. This particular bylaw, which constituted § 7 of Article III of the bylaws, read, in part:

> Executive Committee. The Board of Directors may, by the vote of a majority of the entire board, designate three or more directors to constitute and serve as an Executive Committee, which committee to the extent provided in such resolution, shall have and may exercise all of the authority of the Board of Directors in the management of the corporation. Such committee shall consist of one member from the family of M.K. Blount, Sr., one member from the family of E.H. Taft, Jr., and one member from the family of Ford McGowan. Minutes of all such meetings shall be kept and a copy mailed to each member of the Board of Directors and action of the committee shall be submitted to the Board of Directors at its next meeting for ratification. . . .

Id.

[147] *Id.* This portion of § 7 of the bylaws provided: "The Executive Committee shall have the exclusive authority to employ all persons who shall work for the corporation and that the employment of each individual shall be only after the unamimous consent of the committee and after interview." *Id.*

[148] *Id.* at 767.

[149] *Id.* at 768. Section 7 of the bylaws was replaced by a new § 9, which read:

> 9. Executive Committee: The Board of Directors may, by resolution adopted by a majority of the number of directors fixed by resolution under these bylaws, designate two or more directors to constitute an Executive Committee, which Committee, to the extent provided in such resolution, shall have and may exercise all of the authority of the Board of Directors in the management of the corporation.

Id.

[150] *Id.*

to changing the old bylaws[151] and brought suit to enforce the original shareholders' agreement contained in the old bylaws.[152] The trial judge held that the former bylaw provision relating to the appointment and powers of an executive committee constituted a valid and binding shareholders' agreement under the North Carolina Business Corporation Act,[153] which could not be amended or repealed except by unanimous consent of all the shareholders.[154] He therefore ordered specific enforcement of the bylaw provisions.[155]

Reversing the trial judge's decision, the court of appeals found nothing to support the conclusion that the bylaw provision pertaining to executive committees could not be amended in the same manner as other bylaws of the corporation.[156] On appeal to the Supreme Court of North Carolina, the court affirmed the decision of the court of appeals.[157] The state supreme court took the position that since the shareholders' agreement concerning executive committees and the employment of corporate personnel was only one of a complete set of bylaws adopted at the same time by all the shareholders, it should be considered as subject to change or repeal in the same manner as any of the other bylaws unless provided otherwise.[158] The court conceded that had the bylaw been merely "a 'side agreement' signed by all the stockholders, and not been made a part of the bylaws, it is plausible to argue that absent an internal provision governing its amendment it could be amended only by unanimous consent of all the stockholders."[159] Since, however, it took the form of a bylaw, the court reasoned that it was "subject to amendment by the directors

[151] *Id.* at 767. The Blount faction protested that the new bylaws were an effort on the part of the majority shareholders, particularly the Taft family, to change the bylaws to suit the interests of that family. The Taft faction countered that the bylaws were being changed because of the lack of cooperation by the Blount family in the conduct of the business. *Id.*

[152] *Id.* at 764.

[153] N.C. GEN. STAT. § 55-73(b) (1975).

[154] 246 S.E.2d at 768.

[155] *Id.*

[156] Blount v. Taft, 225 S.E.2d 583 (N.C. Ct. App. 1976).

[157] 246 S.E.2d at 773.

[158] *Id.* at 771.

[159] *Id.* at 772.

or shareholders according to the procedures applicable to the other bylaws."[160] Accordingly, concluded the court, "[w]e hold . . . that if a shareholders' agreement is made a part of the charter or bylaws it will be subject to amendment as provided therein or, in the absence of an internal provision governing amendments, as provided by the statutory norms."[161]

This decision by the North Carolina Supreme Court illustrates the care that must be exercised in formulating shareholder agreements relating to the government of closely-held corporations.[162] If any such arrangements are to become a part of the internal structure of the corporation embodied in the charter or bylaws of the corporation, consideration should be given to the inclusion of special provisions prohibiting amendments without the consent of all participants in the arrangement.[163] Otherwise, minority interests may be exposed, as in *Blount,* to risks which they may not have contemplated.[164]

D. *Foreign Corporations*

Finally, a case from the Kentucky Court of Appeals, *Abbott v. Southern Subaru Star, Inc.,*[165] underscores the signifi-

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[160] *Id.*

[161] *Id.*

[162] For a discussion of matters which may be covered by a shareholders' agreement, see 1 F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE § 5.02 (2d ed. 1971).

[163] *Id.* § 3.78.

[164] For a more extensive analysis of the *Blount* decision and its ramifications for shareholders in close corporations, *see* Note, *Close Corporations—The Amendment of Shareholder Agreements in North Carolina—Blount v. Taft,* 15 WAKE FOREST L. REV. 531 (1979).

[165] 574 S.W.2d 684 (Ky. Ct. App. 1978). For other recent Kentucky cases of interest decided by the court of appeals, *see* White v. Winchester Land Dev. Corp., 584 S.W.2d 56 (Ky. Ct. App. 1979)(where formalities of corporate existence had been observed and creditor had knowledge of financial status of corporation there was no reason to pierce corporate veil); American Commercial Lines, Inc. v. Ostertag, 582 S.W.2d 51 (Ky. Ct. App. 1979)(existence of common directorships and joint credit agreements between parent and subsidiary corporations was not enough to warrant piercing the corporate veil); Simpson v. Heath & Co., 580 S.W.2d 505 (Ky. Ct. App. 1979)(president of corporation who signed agreement as guarantor of corporate contract which he executed as president of corporation was not individually liable on guaranty as a matter of law when he appended to his signature on the guaranty the letters "Pres."); Hutto v. Bockweg, 579 S.W.2d 382 (Ky. Ct. App. 1979) (three-year statute of limitations in Kentucky Securities Act for actions based on securities fraud not unconstitutional as special legislation because of presence of a five-year statute of

cance of the foreign corporation provisions in state corporation statutes.[166] These provisions customarily require foreign corporations to take certain steps to qualify themselves to transact business in the state and prescribe certain penalties should those companies fail to do so.[167]

Under the Kentucky Business Corporation Act,[168] the basic requirement is that a foreign corporation wishing to transact intrastate business must procure a "certificate of authority" from the Secretary of State.[169] Application for such a certificate of authority must be made on forms prescribed and furnished by the Secretary of State containing specified information about the corporation and its business.[170] Duplicate originals of the application must be delivered to the Secretary of State, together with a copy of the corporation's articles of incorporation which have been duly authenticated by the proper officer of the state or country of incorporation.[171] If the Secretary of State finds that the application meets the necessary requirements, he issues a certificate of authority upon payment of the prescribed fees.[172] The basic penalty imposed on a foreign corporation which fails to secure the required certificate of authority before transacting business in the state is denial of the corporation's right to maintain any suit in the courts of the state until it has obtained the certificate of authority.[173]

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limitations for general actions based on fraud).

[166] The term "foreign corporation" is used to refer to corporations organized in another state or country. See, for example, the definition of "foreign corporation" contained in the Kentucky Business Corporation Act. KY. REV. STAT. § 271A.010(2)(Supp. 1978)[hereinafter cited as KRS]. The term is there defined to mean "a corporation for profit organized under the laws other than the laws of this state for a purpose or purposes for which a corporation may be organized under this chapter." *Id.*

[167] *See* H. HENN, CORPORATIONS § 100 (2d ed. 1970).

[168] KRS § 271A.010-.710 (Supp. 1978). The foreign corporation provisions of the Kentucky Business Corporation Act are derived from the Model Business Corporation Act, which Kentucky adopted in substantial part in 1972. *See* Ham, *Kentucky Adopts a New Business Corporation Act*, 61 KY. L.J. 73 (1972).

[169] KRS § 271A.520 (Supp. 1978).

[170] KRS § 271A.540 (Supp. 1978).

[171] KRS § 271A.545(1)(Supp. 1978).

[172] *Id.* at (2).

[173] KRS § 271A.610(1)(Supp. 1978). The Kentucky statute supplements this gen-

In *Abbott,* Southern Subaru Star, Inc., a Texas corporation, and Bug's Distributors, Inc., a Kentucky corporation, held distributorship agreements with an importing firm, Subaru of America, Inc., for the sale of automobiles to retail dealers in several southern states.[174] The corporations decided to enter into joint venture for this purpose and formed a separate corporation under Kentucky law, Subaru of the South, Inc., which became the distributor of the vehicles.[175] Bug's owned fifty-one percent of the stock in South, with Star owning the remainder.[176] Abbott became the chief operating officer of South and as such managed its affairs.[177] Later, when the business deteriorated, Star filed a complaint in circuit court charging Abbott and Bug's, which Abbott controlled, with converting funds from South.[178] When the defendants failed to comply with various court orders, including an order to file a pretrial memorandum, the court entered a default judgment in favor of the plaintiff.[179] As a subsequent hearing ordered by the court on the issue of damages, the defendants filed a motion to dismiss the complaint on the ground that

eral sanction by providing that before the corporation can use the courts of the state, the corporation must have, in addition to obtaining a certificate of authority, (a) paid to the Secretary of State a forfeiture of $250, (b) furnished the Secretary of State with information as to the time the corporation began to transact business in the state, (c) obtained from the Secretary of State a certificate that the corporation has paid all fees which would have been imposed on the corporation had it duly applied for and received a certificate of authority, and (d) filed with the Secretary of State a certificate from the Commissioner of Revenue that the corporation has paid all income and license taxes owed to the state. *Id.* at (2). This additional provision, modeled after a similar Ohio statute, was included to discourage deliberate violations of Kentucky law by foreign corporations at the expense of locally incorporated businesses. *See* OHIO REV. CODE ANN. § 1703.29 (Page 1978).

There are also criminal penalties imposed on corporations and their officers and directors for violating the provisions of the Kentucky Business Corporation Act. *See* KRS § 271A.640 (Supp. 1978). It is provided that any foreign corporation which transacts business in the state without complying with the provisions of the statute, and any officer, director or agent of the corporation who knowingly participates in such unauthorized business is subject to a fine for each offense of not less than $100 nor more than $1,000. *Id.* at (1).

[174] 574 S.W.2d at 685.

[175] *Id.*

[176] *Id.*

[177] *Id.*

[178] *Id.*

[179] *Id.* at 686-87.

plaintiff had failed to qualify to transact business in Kentucky and thus was precluded from maintaining suit in the Kentucky courts.[180] The court overruled this motion.[181] On appeal, the court of appeals affirmed the action taken by the trial court in overruling the motion to dismiss,[182] pointing out that under the Kentucky Rules of Civil Procedure, the capacity of a party to sue is a matter of defense which must be pleaded by "specific negative averment,"[183] and "failure to so plead specifically is a waiver of that defense."[184]

Thus, not only must foreign corporations be attentive to the required qualification procedures when they do business in states other than their state of incorporation, but, as the *Abbott* case teaches, counsel representing clients in the "qualifying" states must be alert to the procedural requirements for raising the lack of qualification of such corporations on behalf of their clients.[185] As the court of appeals noted in *Abbott*, the statutory provisions relating to qualification do not pertain to jurisdiction but to capacity to sue.[186] This is because "jurisdiction refers to the power of a court to hear and determine the subject matter of the litigation while capacity deals with the ability of a party to participate in that litigation."[187]

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[180] *Id.* at 687.

[181] *Id.*

[182] *Id.* at 688.

[183] KY. R. CIV. P. 9.01. This rule provides in part: "When a party desires to raise an issue as to . . . the capacity of any party to sue . . . he shall do so by specific negative averment, which shall include such supporting particulars as are peculiarly within the pleader's knowledge." *Id.*

[184] 574 S.W.2d at 687.

[185] The majority rule is that a defense based on the failure of a foreign corporation to comply with conditions precedent to its right to do business in the state must be specially pleaded, and that a general denial in the answer is insufficient. *See* 18 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8622 (rev. perm. ed. 1977).

[186] 574 S.W.2d at 688.

[187] *Id.* An underlying issue not before the court, but to which the court alluded, was whether a foreign corporation can be denied a right to sue in the courts of the state for tortious injury to its property (such as through conversion) where it has failed to comply with the requirements for doing business in the state. *Id.* Although the Kentucky statutory provisions denying access to the courts by such a foreign corporation cover "any action, suit or proceeding," the court recognized that there might be a constitutional problem if this language were to be interpreted to preclude use of the courts by the corporation to recover for tortious injuries. *See* KY. CONST. § 14.

This provision states that "[a]ll courts shall be open and every person, for an injury done him in his lands, goods, person or reputation, shall have remedy by due course of law, and right and justice administered without sale, denial or delay." *Id. See* Borderland Coal Sales Co. v. Walker, 270 S.W. 717 (Ky. 1925). *See generally* 18A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 8795, 8796 (rev. perm. ed. 1977).